

10-23-2009

Can a Roth IRA be a Shareholder in an S Corporation?

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Recommended Citation

Harl, Neil E. (2009) "Can a Roth IRA be a Shareholder in an S Corporation?," *Agricultural Law Digest*: Vol. 20 : No. 20 , Article 1.
Available at: <http://lib.dr.iastate.edu/aglawdigest/vol20/iss20/1>

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Agricultural Law Press

Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

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Agricultural Law Digest

Volume 20, No. 20

October 23, 2009

ISSN 1051-2780

Can a Roth IRA be a Shareholder in an S Corporation?

-by Neil E. Harl*

Initially, as enacted in 1958,¹ trusts could not be shareholders in an S corporation.² In a series of enactments beginning in 1982, several different types of trusts were authorized to hold stock in an S corporation including grantor trusts,³ grantor trusts that continue to hold stock after death of the deemed owner for up to two years,⁴ testamentary trusts for up to two years,⁵ voting trusts,⁶ electing small business trusts⁷ and, in the case of a corporation which is a bank, "... a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, *but only to the extent of the stock held by such trust in such bank or company*"⁸ In addition, under a special rule, a "Qualified Subchapter S Trust" can hold stock in an S corporation by election with the trust treated as a grantor trust.⁹

But what about IRAs or Roth IRAs that do not hold S corporation bank stock?

Even though S corporation banks were permitted to have individual retirement accounts and Roth IRAs as shareholders,¹⁰ for bank stock held by the IRAs as of October 22, 2004,¹¹ the position of the Congress (and the Internal Revenue Service) has been that IRAs otherwise could not own stock of an S corporation.¹² Now, the Tax Court has agreed in holding that a Roth IRA is not an eligible S corporation shareholder¹³ which caused the S corporation to be taxable as a C corporation in the year the stock ownership passed to the Roth IRA. It is important to note that the opinion was agreed to by 12 judges with four dissenting. Five of the majority judges signed a concurring opinion. Thus, the Tax Court, in a full Tax Court decision, was divided.¹⁴

The taxpayer made two arguments in support of IRA and Roth IRA ownership of S corporation stock other than banks.¹⁵ First, the taxpayer argued that S corporation stock can be held by a custodial account for a disabled person or by a custodian under the Uniform Gifts to Minors Act (or the Uniform Transfers to Minors Act) and is treated as held by the disabled person or child.¹⁶ The taxpayer argued that the regulations¹⁷ provide that "... [t]he person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation" The taxpayer's other argument was that an IRA is essentially a grantor trust that qualifies as an S corporation shareholder under the statute.¹⁸

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The Internal Revenue Service argued, in response, that an IRA custodial account is very different from the custodial accounts that were the subjects of the 1966 Revenue Ruling¹⁹ and the private letter ruling cited by the taxpayer.²⁰ Basically, the IRS argued that the beneficiary of an IRA is not taxed currently on the IRA's share of the S corporation's income but the beneficiaries of the types of trusts that are made specifically eligible to hold S corporation stock²¹ are taxed currently on the trust's share of S corporation income. Moreover, the IRS had made it clear in a 1992 Revenue Ruling²² that a trust qualifying as an IRA is not a permitted shareholder of an S corporation.

The Tax Court noted, as a technical matter, that IRAs and Roth IRAs are not governed by the grantor trust provisions of the Internal Revenue Code²³ and IRS has consistently applied its 1992 Revenue Ruling²⁴ in a series of letter rulings.²⁵ Moreover, and more fundamentally, the Tax Court concluded that there is no indication that Congress ever intended to allow IRAs to own S corporation stock other than bank stock.²⁶ The House Report states that "under present law, an IRA cannot be a shareholder of an S corporation."²⁷

Bills introduced in the Congress

In a footnote, the majority opinion stated that, on May 7, 2009, a bill was introduced in the U.S. Senate that would have expanded S corporation stock ownership eligibility to include all traditional IRAs and Roth IRAs.²⁸ The same proposal was introduced in the Senate in each of the two preceding Congresses.²⁹ None of the bills has passed and been signed into law, however.

Widespread belief that IRAs and Roth IRAs could hold S corporation stock

The Tax Court dissenting opinion noted that *Taproot Administrative Services, Inc. v. Commissioner*³⁰ and its companion cases "... are only a few of nearly a hundred pending before the Court."³¹ The belief that IRAs and Roth IRAs could hold stock in an S corporation has been widespread.

An appeal from the sharply divided Tax Court decision seems likely.

ENDNOTES

¹ Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1650 (1958).

² Treas. Reg. § 1.1371-1(e), before amendment of I.R.C. § 1371 by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982). See *American Nurseryman Pub. Co. v. Comm'r*, 75 T.C. 271 (1980) (transfer of S corporation stock to grantor trust in 1975 terminated Subchapter S election even though state court order held transfer to be void). See generally 7 Harl, *Agricultural Law* § 56.06[2][b] (Matthew Bender 2009); Harl, *Agricultural Law Manual* § 7.02[3][c] (Agricultural Law Press 2009); Harl, *Farm Income Tax Manual* § 7.04[2][c][iv]

(Matthew Bender 2009 ed.).

³ I.R.C. § 1361(c)(2)(A)(i).

⁴ I.R.C. § 1361(c)(2)(ii).

⁵ I.R.C. § 1361(c)(2)(iii).

⁶ I.R.C. § 1361(c)(2)(iv).

⁷ I.R.C. § 1361(c)(2)(v).

⁸ I.R.C. § 1361(c)(2)(vi) (emphasis added).

⁹ I.R.C. § 1361(d), (c)(i).

¹⁰ I.R.C. § 1361(c)(2)(vi).

¹¹ Pub. L. No. 108-357, § 233(a).

¹² Rev. Rul. 92-73, 1992-2 C.B. 356 (trust qualifying as an IRA is not a permitted shareholder of an S corporation).

¹³ *Taproot Administrative Services, Inc. v. Comm'r*, 133 T.C. No. 9 (2009).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Rev. Rul. 66-266, 1966-2 C.B. 356; Ltr. Rul. 8505028, November 4, 1985.

¹⁷ Treas. Reg. § 1.1361-1(e)(1).

¹⁸ I.R.C. § 1361(c)(2)(A)(i).

¹⁹ Rev. Rul. 66-266, 1966-2 C.B. 356.

²⁰ Ltr. Rul. 8505028, November 4, 1985.

²¹ I.R.C. § 1361(c)(2)(A), (d).

²² Rev. Rul. 92-73, 1992-2 C.B. 224.

²³ I.R.C. §§ 671-679.

²⁴ Rev. Rul. 92-73, 1992-2 C.B. 224.

²⁵ E.g., Ltr. Rul. 200915020, December 19, 2008.

²⁶ H. Rep. 108-548 (Part 1), at 129 (2004).

²⁷ *Id.*

²⁸ S. 996, 111th Cong., 1st Sess., § 6(a) (2009). See *Taproot Administrative Services, Inc. v. Comm'r*, 133 T.C. No. 9 (2009), footnote 25.

²⁹ S. 3063, 110th Cong., 2d Sess. § 6(a) (2008); S. 3838, 109th Cong., 2d Sess. § 102(a) (2006).

³⁰ 133 T.C. No. 9 (2009).

³¹ *Id.*, footnote 3 of the dissenting opinion.